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Ibero-American Institute for Law and Finance

Working Paper Series 6/2018

The Future of Reorganization Procedures in the Era of Pre-Insolvency Law

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First Draft: December 6, 2018

This draft: September 1, 2019

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Abstract

Several countries and regions around the world, including Singapore, the United Kingdom, and the European Union are amending their restructuring framework to implement a pre-insolvency mechanism that includes most of the features existing in the US Chapter 11. However, unlike what happens in the United States, where unsuccessful reorganizations lead to Chapter 7 liquidations, companies using this '*de facto* Chapter 11' (DFCH11) will be still allowed to use formal reorganization procedure. This paper argues that, while the rise of the DFCH11 is not necessarily undesirable provided that various protections are put in place, jurisdictions implementing this restructuring tool need to adapt their formal insolvency framework to this new era of 'pre-insolvency law'. Otherwise, some inefficiencies can be created from the lack of coordination between insolvency and pre-insolvency law, since non-viable firms as well as viable businesses managed by the wrong people can opportunistically delay the commencement of a liquidation procedure even when it is the most desirable outcome.

Summary

1. Introduction

Many jurisdictions around the world are amending their restructuring framework to implement various types of pre-insolvency mechanisms, including what this article calls a '*de facto* Chapter 11' (DFCH11).[2] A DFCH11 is a restructuring tool that, even if it is designed as a pre-insolvency mechanism[3] and exists along with formal reorganization procedures, provides debtors with most of the features existing in a US Chapter 11 reorganization procedure, including a moratorium, cross-class cramdown, and the availability of debtor in possession (DIP) financing. Moreover, due to the pre-insolvency nature of this procedure, the managers are allowed to keep running the firm without the intervention of any supervisor or trustee, as it also happens in the US Chapter 11. Therefore, this pre-insolvency mechanism looks like a Chapter 11 reorganization procedure. It only differs in three primary aspects. First, while the DFCH11 seeks to help debtors when they are not insolvent yet, a Chapter 11 reorganization procedure may serve as both a pre-insolvency procedure and a formal insolvency proceeding seeking to assist viable companies unable to pay debts.[4] Second, unlike what happens in the United States where a failure to reach a reorganization agreement under a Chapter 11 procedure leads to a Chapter 7 liquidation, companies in jurisdictions with a

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[2] These jurisdictions include Singapore, the United Kingdom and the European Union. For an analysis of the insolvency reforms in Singapore, see Gerard McCormack and Wai Yee Wan, *Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges*, JOURNAL OF CORPORATE LAW STUDIES (2018); Meng Seng Wee, *Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?* Working Paper (2017) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922956). For the European Union, see Rolef de Weijs, *Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide*, 15 (2) EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 403 (2018); Horst Eidenmüller, *Contracting for a European Insolvency Regime*, 18 EUROPEAN BUSINESS AND ORGANIZATION LAW REVIEW 273 (2017). For a general overview of the insolvency reforms planned in the United Kingdom, see Jennifer Payne, *The Government announces radical changes to the UK debt restructuring regime*, OXFORD BUSINESS LAW BLOG, 11 September 2018 (available at https://www.law.ox.ac.uk/business-law-blog/blog/2018/09/government-announces-radical-changes-uk-debt-restructuring-regime).

[3] This article will use the term 'pre-insolvency proceeding' to refer to procedures usually characterized by two aspects. First, debtors are not formally insolvent yet. Second, debtors cannot enjoy certain tools available in insolvency proceedings. Therefore, the concept can capture both: (i) procedures that are not formally considered insolvency proceedings and just provide debtors with one or a few 'insolvency tools', such as the availability to impose a plan on some dissenting creditors *within* a class as it allows the UK Scheme of Arrangement; and (ii) procedures that, as it happens with the Singapore Scheme of Arrangement, are formally considered insolvency proceeding, provide various tools traditionally existing in formal reorganization procedures but do not usually require a situation of insolvency as a financial requirement to have access to the procedure. For an analysis of the definition, goals and features of pre-insolvency proceedings, see Nicolaes Tollenaar, PRE-INSOLVENCY PROCEEDINGS: A NORMATIVE FOUNDATION AND FRAMEWORK (Oxford University Press, 2019), pp. 38-98, 188-250. See also José María Garrido, OUT-OF-COURT DEBT RESTRUCTURING (World Bank Studies 2012), pp. 2-6; Horst Eidenmüller, *What is an insolvency proceeding*? ECGI LAW WORKING PAPER No 335/2016 (https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2712628.pdf); Bob Wessels and Stephan Madaus, *Instrument of the European Law Institute: Rescue of Business in Insolvency Law* (2017), (https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf), pp. 183-190.

[4] For the purpose of this article, 'insolvency proceedings' and 'bankruptcy procedures' will be used as synonyms.

DFCH11 are still allowed to use formal reorganization procedures. Third, despite the similarities between the US Chapter 11 and the pre-insolvency proceedings implemented in many jurisdictions, there are still some tools exclusively available in formal reorganization procedures (e.g., avoidance actions).

This paper argues that, while the rise of this DFCH11 is not necessarily undesirable provided that some protections are put in place, jurisdictions implementing this new restructuring tool need to adapt their formal insolvency framework to this new era of 'pre-insolvency law'. Otherwise, some inefficiencies might be created from the lack of coordination between insolvency and pre-insolvency law. Namely, it will be argued that the rise of the DFCH11 proposed or adopted in several jurisdictions around the world, including Singapore, the United Kingdom and the European Union, should lead to restricting the use of formal reorganization proceedings. After all, if companies do not use a pre-insolvency mechanism that may facilitate, at a lower cost, a financial restructuring by providing some tools traditionally existing in a Chapter 11 reorganization, or these pre-insolvency agreements fail, there will be reasons to believe that either the company is not viable or the creditors do not trust the managers. In either case, the company will not deserve to be reorganized. Therefore, unless some enhanced controls are put in place to prevent these companies from using formal reorganization procedures, there will be an increase in the number of debtors opportunistically filing for reorganization. And if so, creditors can respond with an increase in the cost of debt and value can be lost –at the expense the company, the employees, and the creditors as a whole– if non-viable firms are not quickly liquidated piecemeal and viable businesses are not sold as a going concern to a third party.

This article is divided as follows. Section 2 discusses how countries and regions around the world are implementing a DFCH11. It also analyses the features and desirability of the primary features of the DFCH11, and why countries may have decided to implement a DFCH11 rather than a formal Chapter 11 reorganization procedure. Section 3 explains how and why countries implementing a DFCH11 should adapt their insolvency regimes to this new era of pre-insolvency law. Section 4 concludes.

2. The rise of pre-insolvency law

2.1. Introduction

There are several ways to sort out a debtor´s financial trouble. Perhaps, a simple way to classify debt restructuring tools can be drawn from the distinction between 'formal' and 'non-formal' insolvency proceedings. By formal insolvency proceedings, this paper will refer to those procedures provided by the legislator characterized by (i) the existence of a situation of insolvency[5] or, at least, a collective action problem,[6] (ii) a

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[5] The concept of insolvency differs across jurisdictions. In general, there are two general concepts of insolvency: (i) balance-sheet insolvency, whenever a debtor´s liabilities exceed the value of the company´s assets; and (ii) cash-flow insolvency, whenever a debtor is unable to pay its debts as they fall due. For a detailed analysis of these concepts, see Roy Goode, PRINCIPLES OF CORPORATE INSOLVENCY LAW (Sweet & Maxwell, 4th Edition, 2011), pp. 109-147. Likewise, some jurisdictions, such as Germany and Spain, have also introduced the concept of

court in charge of overseeing the insolvency proceeding,[7] (iii) special provisions to modify debt contracts without requiring the unanimity rule existing outside of bankruptcy,[8] (iv) the protection of a moratorium,[9] (v) special rules for the treatment of contracts and new financing, and (vi) the imposition of, or at least the ability to appoint under some circumstances, a trustee to manage or supervise the insolvency proceeding.[10]

In contrast, the concept of 'non-formal insolvency procedures' used in this paper will include those debt restructuring tools that generally lack some of these features. Therefore, it will include, among others, the following mechanisms: (i) *workouts* or totally out-of-court debt restructuring agreements between debtors and creditors; (ii) *mediation and conciliation* proceedings, in which third parties are appointed to facilitate or propose a solution, respectively; (iii) *scheme of arrangements*, in which some special rules regarding voting, creditor classification and approval will apply; and (iv) a

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'imminent insolvency' to refer to those situations in which, even though a debtor is still able to pay its debts, it will unlikely be able to do so at some point in the near future (see, for example, article 2.3 of the Spanish Act and article 18 of the German Insolvency Act). For the purpose of this article, insolvency will be generally understood as inability to pay debts. Therefore, we will follow a cash-flow test, even though, in well-functioning markets, companies should become cash-flow insolvent once they are *already* balance-sheet insolvent. Otherwise, they should be able to borrow money. As a result, by 'insolvent company', this article will usually refer to companies that face a situation of both cash-flow insolvency and balance-sheet insolvency, even if, of course, balance-sheet insolvent firms can be in a situation of cash-flow solvency (as it may happen with many start-ups and companies reporting accounting losses but still with enough cash-flows to meet their payment obligations) and the other way around, that is, a cash-flow insolvent firm can be balance-sheet solvent – as it may happen in situation in which, due to a credit freeze, companies are unable to borrow money, even if they have enough unencumbered assets to offer to their lenders.

[6] In some jurisdictions, such as the United States, companies are not required to prove a situation of 'insolvency'. However, in the absence of a collective action problem and other similar 'bankruptcy problems', the court may dismiss the case. A situation of insolvency (or even imminent insolvency) usually involves collective action problems. Therefore, there is a potential role of bankruptcy law in these situations. For some authors, solving the collective action problems generated in a situation is one of the primary roles of insolvency law. See Thomas H. Jackson, Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (Harvard University Press, 1986), pp. 1-19.

[7] In some countries, the role of bankruptcy court can be played by some administrative bodies with judicial powers. For the purpose of this article, these administrative bodies in charge of overseeing insolvency proceedings are also included in the concept of 'bankruptcy courts'.

[8] Outside of bankruptcy, debt contracts can only be modified by all creditors. In a formal insolvency proceeding, however, this unanimity rule is no longer required.

[9] This moratorium, as it is called in the United Kingdom and Singapore, or 'automatic stay', as it is referred to in the United States, has been classified as the primary features of insolvency proceedings, since it protects the debtor´s assets against the enforcement actions potentially initiated by the creditors. See Richard Squire, CORPORATE BANKRUPTCY AND FINANCIAL REORGANIZATION (Wolters Kluwer, 2016), p. 13.

[10] For a deeper analysis of the concept and features of insolvency proceedings, see Horst Eidenmüller, *What is an insolvency proceeding*? ECGI LAW WORKING PAPER NO 335/2016. For an analysis of the differences between 'informal' and 'formal' insolvency mechanisms, see José María Garrido, OUT-OF-COURT DEBT RESTRUCTURING (World Bank Studies 2012), pp. 2-6. It should be noted that the appointment of the trustee is not required in some insolvency jurisdictions adopting a debtor in possession, as it is the case of the United States. Under the US Bankruptcy Code, the debtor remains in possession during a Chapter 11 reorganization. Only in Chapter 7 liquidations, as well as exceptional cases in Chapter 11, a trustee is appointed to manage the procedure.

DFCH11, sometimes designed as a type of '*enhanced scheme of arrangement*',[11] which is a more complex restructuring procedure that includes various features of insolvency proceedings, particularly from the US Chapter 11. All of these 'non-formal insolvency proceedings', and especially those requiring some type of regulation, will be included under the concept of 'pre-insolvency law' used in this paper.[12]

2.2. The rise of the DFCH11 around the world

2.2.1. Overview

The US Chapter 11 differs from other reorganization procedures around the world on two primary aspects: (i) the governance of the insolvency proceeding; (ii) and the insolvency tools available to facilitate the reorganization of the company. In terms of

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[11] This type of 'enhanced scheme of arrangement' can be found in Singapore, where the debtor enjoys most of the benefits existing in a Chapter 11 reorganization (e.g., moratorium, cross-class cramdown –different from the one existing in the US Chapter 11 though, since it requires enhanced majorities–,DIP financing, no appointment of supervisors/trustees), but the procedure is conducted through a Scheme of Arrangement rather than a formal reorganization proceeding. Therefore, while debtors in the United States seeking to reorganize their capital structure through a formal reorganization procedure can only file for Chapter 11, companies in Singapore can use both the Scheme of Arrangement and the judicial management. In Spain, a similar restructuring tool applies. However, the procedure is not formally structured as a Scheme of Arrangement, and the debtor does not enjoy some of the 'insolvency tools' available under the 'enhanced scheme of arrangement' existing in Singapore such as the cross-class cramdown and the special regime of rescue financing. Therefore, while both procedures could be classified under the broad concept of DFCH11 used in this paper, there will be different levels of intensity of DFCH11, depending on the number of insolvency tools existing in these restructuring procedures. For this purpose, the Singapore Scheme of Arrangement would be a strong-form of DFCH11 while the Spanish pre-insolvency mechanism a low-medium form of DFCH11. For an analysis of the Singapore enhanced scheme, see Gerard McCormack and Wai Yee Wan, *Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges*, JOURNAL OF CORPORATE LAW STUDIES (2018); Meng Seng Wee, *Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?* Working Paper (2017) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922956). For an analysis of the pre-insolvency framework in Spain, see Ignacio Tirado, *Out of Court Debt Restructuring in Spain: A Modernised Framework* (2018) (available at https://www.law.ox.ac.uk/sites/files/oxlaw/tirado_modernised_framework.pdf); Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2783666). For a more detailed analysis of the Spanish restructuring framework, and how it differs from other pre-insolvency proceedings existing in other jurisdictions, see Juana Pulgar Ezquerra, PRECONCURSALIDAD Y REESTRUCTURACIÓN EMPRESARIAL (Wolters Kluwer, 2n Edition, 2016).

[12] Some authors distinguish five types of insolvency proceedings depending on both the level of regulatory intervention and the severity of the debtor´s financial trouble. These procedures include: (i) informal or out of-court proceedings (workouts); (ii) enhanced restructuring; (iii) hybrid procedure; (iv) formal reorganizations; and (v) formal insolvency. See José María Garrido, OUT-OF-COURT DEBT RESTRUCTURING (World Bank Studies 2012), pp. 2-6. For the distinction between 'insolvency law' and 'pre-insolvency law', as well as 'insolvency law' and 'restructuring law', see Sarah Paterson, *Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century*, 35 OXFORD JOURNAL OF LEGAL STUDIES 1 (2015); Stephan Madaus, *Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law,* 19(3) EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 615 (2018); Nicolaes Tollenaar, PRE-INSOLVENCY PROCEEDINGS: A NORMATIVE FOUNDATION AND FRAMEWORK (Oxford University Press, 2019), pp. 8-80, 188-250.

governance, the US Chapter 11 allows incumbent managers to keep running the insolvent firm without the appointment of a supervisor or trustee to oversee the procedure.[13] This is something relatively unique of the US Chapter 11. In general, most countries around the world impose the appointment of an insolvency practitioner to either replace the managers or, if they are allowed to preserve their positions, monitor the management team. Therefore, a DIP can only be seen outside the US in some types of non-insolvency proceedings such as a scheme of arrangement, in which the nature and scope of these tools might not recommend the *mandatory* appointment of a third party to oversee the procedure.

As for the insolvency tools available in a Chapter 11 reorganization, the US Bankruptcy Code provides most of the provisions existing in any formal insolvency regime, such as avoidance actions, special treatment of executory contracts, and the automatic stay. Furthermore, and perhaps more interestingly, it also establishes some additional tools to facilitate a corporate restructuring that are not often found elsewhere. These tools include the super-priority status given to certain post-petition financing ('DIP financing'), as well as the ability to impose a plan on some dissenting *classes* of creditors ('cross-class cramdown').[14]

In recent years, many countries around the world, including Singapore, the United Kingdom, and the European Union, are amending their *pre-insolvency* framework to implement some of these features existing in the US Chapter 11.[15] Namely, these new

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[13] For a general overview about different models of 'insolvency governance', see Horst Eidenmüller, *Comparative corporate insolvency law*, ECGI LAW WORKING PAPER NO 319/2016 (available at https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2799863.pdf), pp. 14-16.

[14] Most jurisdictions around the world provide a moratorium, special rules to approve a plan without the consent of all the creditors, and new rules for executory contracts and post-petition financing. Nevertheless, the US Chapter 11 differs significantly from other reorganization regimes in at least three aspects. First, unless most jurisdictions around the world, which only provides an *intra*-class cramdown (that is, the possibility of imposing the plan on dissenting creditors within the same class), the US Chapter 11 provides a powerful cross-class cramdown that only requires the approval of a single class of creditors to impose the class on other classes, provided that other conditions are met (mainly respect of the absolute priority rule and no discrimination unfairly). Second, while many jurisdictions around the world only gives preferential treatment to post-petition lenders, the US Chapter 11 provides a system that, under some circumstances, may give this preferential treatment altering pre-existing creditors' rights. Finally, unlike most formal reorganization procedures around the world, the US Chapter 11 does not impose the appointment of a supervisor or trustee to oversee the insolvency proceeding.

[15] For an analysis of the insolvency reforms in Singapore, see Gerard McCormack and Wai Yee Wan, *Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges*, JOURNAL OF CORPORATE LAW STUDIES (2018); Meng Seng Wee, *Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?* Working Paper (2017) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922956). For a study of pre-insolvency proceedings in Europe, see Lorenzo Stanghellini, Rizwaan J. Mokal, Christoph G. Paulus, and Ignacio Tirado (eds.), BEST PRACTICES IN EUROPEAN RESTRUCTURING: CONTRACTUALISED DISTRESS RESOLUTION IN THE SHADOW OF THE LAW (Wolters Kluwer, 2018). Analysing the European Directive on Preventive Frameworks and Second Chance, see Gerard McCormack, *Corporate Restructuring Law – A second chance for Europe?* 42 EUROPEAN LAW REVIEW 532 (2017); Horst Eidenmüller, *Contracting for a European Insolvency Regime*, 18 EUROPEAN BUSINESS AND ORGANIZATION LAW REVIEW 273, 289-291, 298-303 (2017). For a general overview about the insolvency reforms taking place in the United Kingdom, see Jennifer Payne, *The Government*

pre-insolvency proceedings seek to provide debtors with a moratorium and restriction of *ipso facto* clauses, which are tools that typically exist in formal reorganization proceedings,[16] as well as some provisions specifically provided in the US Chapter 11 (e.g., cross-class cramdown and the super-priority given to certain post-petition financing). Moreover, due to the 'pre-insolvency nature' of these procedures, the debtor will usually remain in possession without the supervision of an insolvency practitioner,[17] which is something new for many restructuring procedures around the world usually characterized by the appointment of a supervisor or trustee.[18]

While the new restructuring framework implemented in many jurisdictions around the world looks like a Chapter 11 reorganization, it differs from the US reorganization procedure on two primary aspects. First, unlike the US Chapter 11, this new restructuring tool is being implemented as a *pre-insolvency* proceeding.[19] Therefore, unless countries implementing the DFCH11 decide to abolish their formal reorganization procedures, debtors coming from a *failed* DFCH11 can still file for reorganization, which is something that it is not possible in the United States – where failed Chapter 11 reorganizations lead to Chapter 7 liquidations. Second, even though a DFCH11 may enjoy many tools existing in the US Bankruptcy Code, other insolvency provisions traditionally existing in a formal Chapter 11 (e.g., avoidance actions, special ranking of claims, executory contracts) will remain exclusively available for formal reorganization procedures. For this reason, this new restructuring tool is best understood as a 'de facto', rather than an actual, Chapter 11 reorganization.

2.2.2. The DIP as a governance system for insolvency proceedings

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announces radical changes to the UK debt restructuring regime, OXFORD BUSINESS LAW BLOG, 11 September 2018 (available at https://www.law.ox.ac.uk/business-law-blog/blog/2018/09/government-announces-radical-changes-uk-debt-restructuring-regime).

[16] The use of a moratorium is provided in most (if not all) insolvency jurisdictions around the world, since it is probably the most important insolvency tool to preserve value. In the absence of the automatic stay, creditors would be incentivized to start a 'race to collect' that may end up destroying the going concern value potentially existing in the insolvent firm, in addition to increasing collection costs for the creditors. See Thomas H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (Harvard University Press, 1986), pp. 16-17. The prohibition to enforce *ipso facto* clauses after the commencement of a restructuring/insolvency proceeding is a more controversial issue. For this reason, the enforceability or not of these clauses significantly differ across jurisdictions, usually depending on how debtor-friendly or creditor-friendly a jurisdiction might be. In debtor-friendly jurisdictions (e.g., USA), these clauses will unlikely be enforced. In creditor-friendly jurisdictions (e.g., Singapore before the 2018 Insolvency Bill), these clauses can be enforced and therefore the debtor´s counterparty can terminate the contract.

[17] In the United Kingdom, however, the new restructuring tool will likely require the appointment of an insolvency practitioner to oversee the reorganization process.

[18] The appointment of a supervisor or trustee has been something common in most reorganization procedures around the world, including those existing in the United Kingdom, Singapore, and most countries in Continental Europe.

[19] The distinction between 'insolvency' and 'pre-insolvency' law is becoming even more unclear in this new era of 'pre-insolvency law'. As Eidenmüller mentions, if any US fellow looks at the features of the 'enhanced Scheme of Arrangement' existing in Singapore or the new restructuring tool implemented in Europe, they would probably think that it is a formal reorganization procedure, despite the fact that the procedure does not provide some 'insolvency tools' traditionally existing in bankruptcy (e.g., avoidance actions). See Horst Eidenmüller, *Contracting for a European Insolvency Regime*, 18 EUROPEAN BUSINESS AND ORGANIZATION LAW REVIEW 273, 290.

2.2.2.1. The costs and benefits of a DIP regime

The implementation of a DIP as a system of governance for insolvency proceedings may have several advantages. First, it can save the costs associated with the remuneration of a supervisor or trustee. Therefore, it can increase the pie available for distribution, what it will lead to lower recoveries for the creditors, and therefore, from an ex ante perspective, a higher cost of debt. Second, the implementation of this model may also reduce the costs associated with disrupting the company´s business relationships with suppliers, consumers, and other stakeholders, in addition to taking advantage of the managers´ existing connections.[20] Third, even though a trustee may be an expert in corporate reorganizations, it might lack the expertise of a particular business or economic sector. Therefore, it might not make the most value-maximizing decisions for a particular business. Fourth, under a DIP, the managers keep their jobs after the commencement of the insolvency proceeding. Thus, they will have more incentives to file for bankruptcy at a timely manner. Fifth, the system of appointment of trustees is far from perfect. In countries where the debtor can appoint the administrator, as it may happen in the UK, the trustee may have perverse incentives to favor the debtor over the creditors. In countries where the creditors play a major role in the appointment of the trustee, as it happens in Germany and Singapore, some asymmetries of information, collective action problems, and conflicts of interests may undermine the quality of the decision. Finally, in countries like Spain and Colombia, where the trustee has been traditionally appointed at the discretion of the court among a list of experts, some cases of corruption and conflicts of interests between judges and trustees have been detected, especially in large bankruptcy cases in which the remuneration of the trustee can be very high.[21] Therefore, even though some regulatory tools can be implemented to minimize the costs associated with these existing models,[22] the DIP seems to avoid this problem.

As a result of all of its benefits, insolvency jurisdictions should have strong incentives to implement a debtor in possession. However, while the idea of implementing a DIP may sound very appealing, it can also create some problems. On the one hand, it may allow inefficient (even dishonest) managers to keep running the firm. On the other hand, it may exacerbate the misalignment of incentives between debtors/managers and

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[20] Oliver Williamson, MARKETS AND HIERARCHIES: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION (The Free Press, 1975)

[21] These practices have led the legislator in both jurisdictions to change the system of appointment of trustees. In Colombia, a system of automatized appointment based on an algorithm has been put in place. In Spain, the legislator has decided to implement a system randomly assigned trustees among those included in a list of people meeting certain requirements. However, both jurisdictions still allow, in some exceptional cases, the appointment of the trustee at the discretion of the court. These exceptional appointments usually take place in complex bankruptcy cases. Therefore, the conflict of interests that the legislator sought to solve might not really disappear, since the bankruptcy court will still have the ability to choose the trustee in complex and large bankruptcy cases, which are usually those with higher fees.

[22] The advantages and disadvantages of the debtor in possession, as well as some regulatory proposals to improve the transparency, effectiveness and efficiency of the existing models of appointment of trustees can be found in Aurelio Gurrea Martínez, EL DERECHO CONCURSAL EN ESPAÑA: PROBLEMAS ESTRUCTURALES Y PROPUESTA DE REFORMA (Reus, 2018), pp. 135-145.

creditors potentially existing in the zone of insolvency.[23] Therefore it may increase the risk that the debtor engages in several forms of opportunistic behaviors (e.g., asset substitution, asset dilution, etc.)[24] even after the commencement of the insolvency proceeding. Moreover, this risk of opportunism becomes even higher in countries with controlling shareholders and small and medium size enterprises (SMEs), since the managers are either the shareholders themselves or closely monitored by the shareholders.[25] Thus, there will be a higher dependency or even identity between shareholders and managers. Therefore, in this type of companies, managers will have more incentives to maximize the interests of the shareholders or, at least, the interests of the controlling shareholders. Even though this situation may be desirable in solvent companies, in the context of financially distressed firms, it may exacerbate the conflicts between shareholders and creditors.

Therefore, the risk of expropriation of shareholders/managers vis-à-vis creditors will be higher in the context of SMEs and large companies with controlling shareholders facing financial trouble. As a result, the implementation of a DIP in countries with this type of companies – which are most countries around the world[26] – not only may create an undesirable transfer of wealth ex post, but it could also lead to an ex ante increase in the cost of debt or more strict covenants that may ultimately harm the levels of entrepreneurship, innovation, and access to finance in the country. Therefore, even though the DIP may create several benefits, jurisdictions seeking to implement this model should carefully analyze and, if so, minimize these problems.[27]

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[23] Michael C. Jensen y William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305, 333-343 (1976).

[24] John Armour, Gerard Hertig and Hideki Kanda, *Transactions with Creditors,* in John Armour, Luca Enriques *et al,* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Oxford University Press, 2017), pp.109-114.

[25] Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2783666); Gerard McCormack and Wai Yee Wan, *Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges*, JOURNAL OF CORPORATE LAW STUDIES (2018).

[26] Rafael La Porta, Florencio López de Silanes, Andrei Shleifer and Robert Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998); Rafael La Porta, Florencio López de Silanes and Robert Vishny, *Corporate Ownership Around the World*, 54 JOURNAL OF FINANCE 471 (1999); Claessens, Stijn, Simeon Djankov and Larry Lang, 2000, *The Separation of Ownership and Control in East Asian Corporations*, 58 JOURNAL OF FINANCIAL ECONOMICS 81 (1999); Fabrizio Barca and Marco Becht (eds.), THE CONTROL OF CORPORATE EUROPE (Oxford University Press, 2002); Luca Enriques and Paolo Volpin, *Corporate Governance Reforms in Continental Europe,* 21 JOURNAL OF ECONOMIC PERSPECTIVES 117 (2007); Andy J.Y. Yeh, Steven Lim and Ed Vos, *Path Dependence or Convergence? The Evolution of Corporate Ownership Around the World,* REVIEW OF LAW AND ECONOMICS 517 (2007); Julian R. Franks and Colin Mayer, *Evolution of Ownership and Control Around the World: The Changing Face of Capitalism,* EUROPEAN CORPORATE GOVERNANCE INSTITUTE (ECGI) - FINANCE WORKING PAPER NO. 503/2017; Ronald W. Masulis, Peter K. Pham and Jason Zein, *Family Business Groups Around the World: Financing Advantages, Control Motivations, and Organizational Choices*, 24 REVIEW OF FINANCIAL STUDIES 3556 (2011).

[27] For example, as a way to solve the first problem associated with a DIP regime (that is, keeping in office inefficient or dishonest managers), the legislator could facilitate the removal of the managers by the creditors. For the second problem, associated with the higher risk of opportunism of shareholders/managers vis-à-vis creditors, the legislator could implement

2.2.2.2. A DIP in pre-insolvency proceedings

The implementation of a DIP may increase the risk of opportunistic behavior existing in the context of distressed firms, which may in return lead to various costs ex ante (e.g., increase in the cost of debt) and ex post (e.g., transfer of wealth from the company´s creditors to the shareholders/managers). However, if a company is just facing financial trouble but it is still solvent and therefore the shareholders are *in* the money, the risk of opportunistic behavior of shareholders vis-à-vis creditors will be significantly reduced. In these circumstances, the shareholders (or the managers on their behalf) will unlikely bet the firm as it may happen in insolvency.[28] Instead, the managers will have incentives to pursue those projects with the highest net present value. Therefore, in solvent firms, or even firms approaching insolvency, the interests of the creditors will be more aligned with the interest of the shareholders. For this reason, a DIP in pre-insolvency procedures may make more sense than a DIP in formal insolvency proceedings, since the shareholders can still be in the money. Thus, as the risk of engaging in opportunistic behavior will be lower in the context of solvent firms just facing or foreseeing financial trouble, the appointment of a trustee might not be necessary as a way to protect creditors. And in companies with dispersed ownership structures –as it is the case of large listed companies in the United Kingdom and the United States[29]– the justification for a trustee will be even weaker since the directors will be more independent from the shareholders. As a result, the risks of favoring the shareholders at the expense of the creditors will be lower in these countries.

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several measures, including new fiduciary duties toward the creditors, a harsher liability regime for breach of fiduciary duties, more power and information given to creditors in bankruptcy, or the creation of a governmental agency to supervise DIPs as it happens in the United States.

[28] This problem, generally known as 'asset substitution', relies on the intuition that the shareholders, once they have lost everything, may have incentives to pursue very risky investments (or ask the managers to do so) even if these projects have a negative net present value but in case of success yield very high returns. Thus, if the project succeeds, the shareholders can still recover part of their investments. Nevertheless, if the project fails (as it is likely the case in this type of projects with negative net present value), the shareholders will lose nothing since they will be protected through the limited liability. Therefore, all the losses will be borne by the creditors. See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305, 333-343 (1976); Paul Davies, 7 *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 301, 306-307 (2006); John Armour, Gerard Hertig and Hideki Kanda, *Transactions with Creditors,* in John Armour, Luca Enriques *et al,* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Oxford University Press, 2017), pp. 111-112; Assaf Eisdorfer, *Empirical Evidence of Risk Shifting in Financially Distressed Firms*, 63 JOURNAL OF FINANCE 609 (2008). Showing that this asset substitution (or 'risk shifting') problem might really happen, however, see Erik Gilje, *Do Firms Engage in Risk-Shifting? Empirical Evidence*, 29 REVIEW OF FINANCIAL STUDIES 2925 (2016); Pablo Hernández, Paul Povel, and Giogo Sertsios, *Does Risk Shifting Really Happen? Results from an Experiment*, Working Paper (2014); B. Espen Eckbo and Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 JOURNAL OF FINANCIAL ECONOMICS 227 (2003).

[29] Rafael La Porta, Florencio López de Silanes, Andrei Shleifer and Robert Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998); Rafael La Porta, Florencio López de Silanes and Robert Vishny, *Corporate Ownership Around the World*, 54 JOURNAL OF FINANCE 471 (1999). However, see Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States,* 44 THE REVIEW OF FINANCIAL STUDIES 1377 (2009).

Therefore, it seems reasonable the solution adopted in Singapore and the European Union, where the appointment of an insolvency practitioner is not formally required in pre-insolvency proceeding,[30] even if *scheme managers* are often appointed in Singapore and a similar patter may occur in Europe. By contrast, the mandatory appointment of insolvency practitioners proposed in the United Kingdom for the new restructuring tool does not seem very convincing.[31] In my opinion, the imposition of an insolvency practitioner to oversee the restructuring process will unnecessarily increase the costs associated with these procedures. Moreover, even though the appointment of an insolvency practitioner may create several gains mainly associated with the credibility and expertise of these professionals (especially in countries with a qualified body of insolvency practitioners as it happens in the United Kingdom), these gains might not exceed their costs. Otherwise, if the benefits associated with appointing an insolvency practitioner really outweighed its costs, the debtor –sometimes encouraged by its creditors– would have incentives to voluntary hire an insolvency practitioner to oversee the restructuring process as it actually happens in many cases nowadays. Therefore, it would not be necessary to provide for the mandatory appointment of a supervisor, especially in a country with dispersed ownership structures such as the United Kingdom. It seems interesting that, while jurisdictions with companies with concentrated ownership structure as it happens in Singapore and the European Union are not imposing the mandatory appointment of a trustee even when there are more reasons to do so (due to the higher risk of opportunism of shareholder/managers vis-à-vis creditors), countries with larger companies with dispersed ownership structures such as the United Kingdom has advocated for this approach. Perhaps, a more convincing argument to understand this reform can be found in the more powerful, organized lobby of insolvency practitioners existing in the United Kingdom.[32]

2.2.3. (Cross-class) Cramdown

Companies facing financial trouble should have incentives to reach an out-of-court restructuring or 'workouts'. Through these non-bankruptcy devices, debtors may enjoy a higher degree of flexibility and, more importantly, they can save significant costs

[30] In insolvency proceedings, however, the appointment of an insolvency practitioner would make more sense in these countries, due to the higher alignment of incentives between managers and shareholders, and therefore the higher risk of opportunism of shareholders/managers vis-à-vis creditors.

[31] For a summary of the proposed reform in the United Kingdom, see https://www.r3.org.uk/index.cfm?page=1949&element=32517&refpage=1865

[32] Lobbies have often influenced the design of business laws. For instance, in the context of takeovers, it has been argued that the powerful lobby of managers in the US and the power of institutional investors in the UK made the regulatory framework of takeovers very director-friendly and shareholder-friendly, respectively, in the US and the UK. See John Armour and David A. Skeel Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEORGETOWN LAW JOURNAL 1727 (2007). Similarly, arguing that the families controlling most European corporations may have influenced the design of takeover law in Europe, see Marco Ventoruzzo, *Takeover Regulation as a Wolf in Sheep's Clothing: Taking UK Rules to Continental Europe*, 11 UNIVERSITY OF PENNSYLVANIA JOURNAL OF BUSINESS LAW 135 (2008). Therefore, since the associations of insolvency practitioners are larger and more established in the United Kingdom, this lobby is probably more powerful than in Singapore or many European countries.

associated with filing for bankruptcy.[33] However, this agreement is not always possible. In the absence of bankruptcy, an adjustment of debts requires the consent of all the creditors. Therefore, not only it is very costly, but it can also lead to various forms of holdout problems. As a way to solve these problems, insolvency legislators provide debtors with various legal devices, including the automatic stay and the possibility of imposing a plan on dissenting creditors.

The ability to impose a plan on dissenting creditors is often called 'cramdown'. There are two types of cramdown though: *inter*-class or cross-class cramdown, and *intra*-class cramdown. An inter-class or cross-class cramdown takes place when a reorganization plan is imposed on one or more dissenting *classes* of creditors. An inter-class cramdown occurs when a plan is imposed on some individual creditors *within* the same class. Therefore, this intra-class cramdown is no more than a majority rule. In the absence of this majority rule, there would be fewer differences between reorganizations in and out of bankruptcy, since totally private reorganizations (workouts) usually require *unanimity* of creditors to modify the debtor´s capital structure. In a formal reorganization procedure, however, or even in some pre-insolvency proceedings such as the Scheme of Arrangement, this unanimity rule is substituted by a majority rule. Otherwise, not only it would be virtually impose to reach a reorganization agreement (especially in large companies with many creditors and complex capital structures), but some holdout problems may also arise since many individual creditors may opportunistically try to blackmail the debtor to get paid first.

In most insolvent firms, the debtor has various classes of creditors. Therefore, even if a majority rule is provided to facilitate the approval of a plan within a class, the debtor will face a second challenge: getting the approval of all the classes. Therefore, it will be more costly to approve a reorganization plan. For this reason, many countries around the world seeking to facilitate corporate reorganizations have moved from their simple majority rule or intra-class cramdown towards a system of inter-class or cross-class cramdown. According to this type of cramdown, the approval of a single class of creditors (something that usually requires a majority of creditors within that class)[34], a

[33] For a review of the costs of bankruptcy, see Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 JOURNAL OF FINANCE 337 (1977), showing that the direct costs of bankruptcy were 3% to 4 % of the pre-bankruptcy market value of total assets in large firms. These figures are relatively consistent with Lawrence A. Weiss, BANKRUPTCY RESOLUTION: DIRECT COSTS AND VIOLATION OF PRIORITY OF CLAIMS, 27 JOURNAL OF FINANCIAL ECONOMICS 285 (1990). However, in Gregor Andrade and Steven N. Kaplan, *How Costly Is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 JOURNAL OF FINANCE 1443 (1998), the authors show the costs of financial distress represents 10-20% of the market value of the firm. These costs, however, seem to be higher in the United Kingdom, at least for small firms. See Julian Franks and Oren Sussman, *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, 9 REVIEW OF FINANCE 65 (2005), reporting that insolvency liquidations subtract 20% to 40% of the company´s proceeds in the context of small and medium size enterprises.

[34] In the US, a plan is deemed approve by a class of creditor if at least a majority in number and 2/3 in value vote in favour the plan. In the Singapore and the United Kingdom, the approval of a plan under a Scheme of Arrangement requires a higher majority (majority in number and at least 75% in value). For a fantastic analysis of the Scheme of Arrangement, with particular focus on the regulation in the United Kingdom but providing an overview about this tool in other jurisdictions, see Jennifer Payne, SCHEMES OF ARRANGEMENT: THEORY, STRUCTURE AND OPERATION (Cambridge University Press, 2014). For the Scheme of Arrangement in Singapore

plan can be imposed automatically on some dissenting *classes* of creditors. Therefore, many costs associated with the approval of a reorganization plan (including time, resources and negotiation efforts) can be saved.

Obviously, a cross-class cramdown (or just 'cramdown' as it is called in the United States) without any further protections could harm some creditors´ rights and could lead to an ex ante increase in the cost of debt in the country. For that reason, a plan can only be crammed down in the United States if several requirements are met, including two primary tests to protect the interests of the different *classes* of creditors as a whole. First, the plan must be fair and equitable.[35] A plan is fair and equitable if it respects the absolute priority rule.[36] Therefore, junior creditors cannot get any value from the firm until senior creditors have been paid in full or allows junior creditors to keep part of the firm´s value, and the shareholders cannot get anything until the creditors have been paid in full or decide to give up part of their claims. Second, the plan should not discriminate unfairly, what basically means that similarly situated creditors should receive a similar payout. By imposing these requirements, debtors can enjoy the benefits of the cross-class cramdown without harming creditors´ rights. Thus, these conditions make the cross-class cramdown a Pareto efficient solution.

In addition to these mechanisms seeking to protect each class of claimants, *individual* creditors also enjoy other protections. Among others, under the best interest of creditors' test existing in the US Chapter 11,[37] creditors are allowed to receive under the reorganization plan at least what they would receive under a hypothetical Chapter 7 liquidation. Therefore, while the cross-class cramdown can be seen as a *pro-debtor* provision, in the sense that it facilitates the approval of a reorganization plan, the best interest of creditor test is a *pro-creditor* provision. Namely, it makes sure that every creditor (including those voting against the approval of the plan) will receive at least what they could get under a hypothetical Chapter 7 liquidation. Therefore, the combination of both the best interest of creditors test and the cross-class cram down seems to create a Pareto improvement, that is, a situation in which some gains are created and nobody is worse off. Moreover, in addition to being beneficial for the parties involved, the best interest of creditor test also promotes the efficient allocation of the debtor´s assets. Therefore, it can also be seen as a desirable tool for society as a whole.

In the absence of the absolute priority rule, the non-discrimination rule and the best interest of creditor test, the existence of a cross-class cramdown would be economically undesirable. Ex post, it would allow insolvent debtors to impose a plan on dissenting creditors, even if the creditors are worse off or unfairly discriminated, or the debtor´s business is not economically viable. As a result, from an ex ante perspective, creditors would be more reluctant to lend money. Therefore, there could be a

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after the 2017 insolvency reform, see Gerard McCormack and Wai Yee Wan, *Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges*, JOURNAL OF CORPORATE LAW STUDIES (2018); Meng Seng Wee, *Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?* Working Paper (2017) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922956)

[35] See 11 U.S. Code § 1129(b)(1)

[36] Douglas G. Baird, ELEMENTS OF BANKRUPTCY (Foundation Press, 5th Edition, 2010), p. 71.

[37] See 11 U.S.C. § 1129(a)(7)

contraction of credit or an undesirable increase in the cost of debt. Alternatively, creditors could also respond with stricter covenants that may end up harming entrepreneurship, innovation and firm´s access to finance.

Hence, any country considering the possibility of implementation of a cross-class cramdown should include other devices to protect creditors such as the best interest of creditor test, the absolute priority rule and the non-discrimination rule. Thus, the insolvency framework would become more attractive to debtors *without* harming creditors. Otherwise, value can be destroyed for society if, for example, by favouring the reorganization of viable debtors in financial distress, the insolvency framework incentivizes an increase in the cost of debt.

Moreover, in countries without previous exposure to the cross-class cramdown, and more generally in the valuation issues regarding the correct application of the cramdown existing in the US Chapter 11, some further requirements can be implemented. For example, under the new insolvency framework in Singapore, the cross-class cramdown can only be applied if, in addition to the requirements existing in the United States (i.e., approval by at least one class, respect of the absolute priority rule, non-discrimination test, etc.), the plan is also approved by a supermajority of creditors representing more than 50% in number and at least 75% of the company´s liabilities. In my opinion, even though this later provision might not be optimal for the promotion of an efficient restructuring framework, it might make sense in jurisdictions in which courts, creditors, debtors, and insolvency practitioners are not familiar with the rationale and provisions of the cross-class cramdown. Otherwise, the existence of the cramdown may do more harm than good, since it may create uncertainty and it can even lead to an ex ante increase in the cost of debt even if creditors do not *perceive* they are protected enough – even if they were. Therefore, in countries without sophisticated courts and insolvency practitioners, and even in countries like Singapore, where notwithstanding the sophistication of the judiciary and the industry, the cramdown is a new provision that requires familiarity with all the issues surrounding it (including valuation issues), additional majorities for the approval of the plan might be desirable, at least while the market becomes familiar with this new restructuring tool.

2.2.4. DIP financing

Lenders might be rationally reluctant to provide funds to insolvent firms due to their higher risk of default. As a result of this lack of finance, many valuable investment projects might be pursued. As a way to solve this underinvestment problem[38], insolvency jurisdictions around the world usually provide new lenders and suppliers

[38] The concept of underinvestment project refers to those situations in which a valuable project cannot be pursued usually by the lack of finance. See Stewart C. Myers and Nicholas S. Majluf, *Corporate Financing and Investment Decisions: When Firms Have Information the Investors Do Not Have*, 13 JOURNAL OF FINANCIAL ECONOMICS 187 (1984). By contrast, the concept of ‘overinvestment’ refers to those situations in which projects with a negative net present value are being financed. See Richard A. Brealey, Stewart C. Myers and Franklin Allen, PRINCIPLES OF CORPORATE FINANCE (McGraw-Hill Irwin, 10th Edition, 2011), p. 291.

with an administrative expense priority in bankruptcy. Thus, they will have more incentives to keep doing business with the debtor.[39]

However, in some cases, an administrative expense priority is not enough. Moreover, as debtors usually lack unencumbered assets to offer to their creditors, it becomes more difficult to have access to new finance. For this reason, the US Bankruptcy Code decided to solve this problem by enacting a variety of exceptional remedies to obtain debtor in possession (DIP) financing.[40] Namely, according to section 364 of the US Bankruptcy Code, debtors can obtain new credit by offering a super-priority status to the new lender. This super priority status can take several forms: (i) getting paid ahead of all administrative expenses; (ii) being secured by a lien that it is not otherwise subject to a lien; (iii) being secured by a junior lien on property of the estate that is subject to a lien; or (iv) in exceptional cases, and subject to various requirements, even being secured by a senior or equal lien on property of the estate.[41]

The DIP financing can be seen as another powerful tool to promote the reorganization of a viable business. For this reason, many countries and regions around the world, including Singapore and the European Union, have decided to incorporate this device in their new restructuring framework. However, since it is not clear whether this exceptional mechanism to obtain new financing may alter pre-existing rights, and therefore it may harm creditors' rights, other jurisdictions, as the United Kingdom, have been more reluctant to implement this provision in their new restructuring framework.[42] In any case, in order for this provision to create a Pareto improvement, or at least to avoid any harmful effects on pre-existing creditors, and ultimately on the cost of debt, some further protections should be put in place. These protections, provided in the US Bankruptcy Code and other jurisdictions replicating the DIP financing model existing in the United States, will be mainly focused on allowing this new financing very exceptionally, and provided that, in addition to protecting existing creditors, debtors proves that they cannot get credit otherwise, and this new financing will make them increase the value of the firm. Therefore, from an economic perspective, these

[39] George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 JOURNAL OF LEGAL STUDIES 225, 249-252 (1992).

[40] For an analysis of the rationale and regulation of DIP financing in the United States, see George G. Triantis, *Theory of the Regulation of Debtor-in-Possession Financing*, 46 VANDERBILT LAW REVIEW 901 (1993); George G. Triantis, *Debtor-in-Possession Financing in Bankruptcy*, in Barry Adler (dir.), RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW (Elgar Publishing, 2018); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 JOURNAL OF LEGAL STUDIES 225, 249-252 (1992); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO LAW REVIEW 1905 (2004); Richard Squire, CORPORATE BANKRUPTCY AND FINANCIAL REORGANIZATION (Wolters Kluwer, 2016), pp. 235-260; Barry E. Adler, Douglas G. Baird and Thomas H. Jackson, BANKRUPTCY: CASES, PROBLEMS AND MATERIALS, FOUNDATION PRESS (4th Edition, 2007), pp. 475-520.

[41] See 11 U.S. Code § 364(c)(d). Similar provisions can be found in the new restructuring framework existing in Singapore.

[42] The United Kingdom has alleged that they have a very efficient lending market and that makes the need for DIP financing less relevant. In my opinion, however, the ability to affect pre-existing creditor´s rights, even if these rights are adequately protected and the new financing creates value for the creditors as a whole, has probably made the UK government to be more concern with the impact of this provision in its lending markets. For this reason, in a recent consultation they stated that they are not in favour of implementing a DIP financing regime in the United Kingdom.

requirements seem to ensure that this new financing creates a Pareto improvement, or a situation in which, while generating some gains, nobody will be worse off. By doing so, the DIP financing regime can create ex post efficiencies without harming ex ante efficiency.

2.2.5. Moratorium

A moratorium or automatic stay[43] prohibits creditors from enforcing their claims against the debtor´s assets. Thus, by avoiding a race to collect, this insolvency tool not only saves collection costs but more importantly it protects the debtor´s going concern value, if any. For this reason, some authors have classified the automatic stay as the most important bankruptcy tool.[44]

Due to the desirability of the automatic stay to facilitate a corporate restructuring, most (if not all) insolvency jurisdictions around the world provide debtors with a type of automatic stay in their reorganization procedures.[45] Thus, the moratorium is not something unique of Chapter 11 reorganizations. The interesting development with the DFCH11 is that, while the moratorium has been traditionally available *only* in formal reorganization proceedings, nowadays countries are allowing to usage of this insolvency tool in their *pre-insolvency* framework.[46] Therefore, companies do not need to file for formal reorganization procedures in order to use this insolvency tool. They can just use the new DFCH11 which is being implemented in many jurisdictions around the world.

2.2.6. Non-enforceability of ipso facto *clauses*

An *ipso facto* clause is a contractual term that allows a party to terminate a contract upon the existence of a specified event. Very often the triggering event is the commencement of a formal insolvency proceeding. By including this type of clauses in a commercial agreement, the counterparty can avoid the harmful effects associated with being involved in an insolvency proceeding.

While these contractual terms may seem desirable for solvent counterparties, it can exacerbate the underinvestment problems potentially faced by viable debtors facing financial trouble. Therefore, in addition to destroying value, the existence of these clauses may reduce the likelihood of reorganizing a viable business in distress. For this reason, countries seeking to provide a more restructuring-friendly environment are amending their insolvency (or pre-insolvency) framework to prohibit the enforcement of

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[43] This article uses the word 'moratorium' (commonly used in the United Kingdom, Singapore and other Commonwealth jurisdictions) and 'automatic stay' (used in the United States) as synonyms.
[44] Richard Squire, CORPORATE BANKRUPTCY AND FINANCIAL REORGANIZATION (Wolters Kluwer, 2016), p. 13.
[45] In general, this automatic stay applies to both unsecured creditors and secured creditors, even though the stay on secured creditors is usually subject to special rules.
[46] Some of the first countries adopting a moratorium outside of formal insolvency proceedings were Singapore and Spain. Nowadays, this moratorium has been proposed for a new restructuring tool in the United Kingdom, as well as for the pre-insolvency mechanism established in the European Directive on Preventing Frameworks.

these clauses, except for some classes of creditors or contracts (e.g., financial contracts).[47]

Even though the treatment of *ipso facto* clauses differs across jurisdictions, those countries restricting the enforcement of *ipso facto* clauses do so by stating that these clauses will not become enforceable for the *sole* fact that a debtor enters a formal insolvency/restructuring procedure. Therefore, if the debtor defaults on payments or it breaches any other contractual terms, the counterparty will be entitled to enforce an *ipso facto* clause, since the enforcement of this contractual term will not be *exclusively* due to the commencement of a formal insolvency/restructuring proceeding.

Whereas the desirability of these provisions might be unclear, it is interesting to observe how these clauses are being implemented in many pre-insolvency frameworks around the world, even when this tool was only available in formal reorganization.[48] Therefore, it reflects how many jurisdictions are moving toward a more debtor-friendly environment and, more importantly for the purpose of this paper, how countries are implementing in their *pre-insolvency* frameworks some tools traditionally existing in formal reorganization procedures.

2.3. Why a DFCH11 instead of a formal Chapter 11 reorganization?

The analysis of the restructuring framework which is being implemented in many jurisdictions around the world seem to reflect an interesting move in the insolvency space. On the one hand, it reflects a rise of pre-insolvency law. On the other hand, it shows how countries are implementing in their pre-insolvency frameworks tools traditionally available only in formal reorganization procedures (e.g., moratorium and non-enforceability of *ipso facto* clauses), and more especially tools exclusively or quasi-exclusively available in the US Chapter 11 such as the cross-class cramdown provision and the availability of DIP financing. Therefore, these tendencies in insolvency law reflects what this article refers to as the rise of a '*de facto* Chapter 11' (DFCH11), that is, a pre-insolvency procedure that looks like a US Chapter 11 reorganization but it differs in three primary aspects. First, while the DFCH11 seeks to help debtors when they are not insolvent yet, a Chapter 11 reorganization procedure may serve as both a pre-insolvency mechanism and a formal insolvency proceeding seeking to help viable companies already unable to pay debts.[49] Second, unlike what happens in the United States where a failure to reach a reorganization agreement under a Chapter 11 procedure leads to a Chapter 7 liquidation,[50] companies in jurisdictions with a DFCH11 are still allowed to use formal reorganization procedures.

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[47] Jurisdictions recently adopting the restriction of *ipso facto* clauses in their pre-insolvency or restructuring framework include Singapore and the European Union.

[48] These countries include, for example, Australia, the United States and Spain.

[49] For a comparison of pre-insolvency proceedings and the US Chapter 11, see Stephan Madaus, *Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law,* 19(3) EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 615 (2018). For an analysis of the features of pre-insolvency procedures from a positive and normative perspective, and comparing these procedures with the US Chapter 11 procedure, see also Nicolaes Tollenaar, PRE-INSOLVENCY PROCEEDINGS: A NORMATIVE FOUNDATION AND FRAMEWORK (Oxford University Press, 2019).

[50] In fact, even unsuccessful workouts may be preventing from using Chapter 11 as a second shot to reorganize a company. See *In Re Colonial Ford, Inc*, 24 B.R. 1014 (1982)

Third, despite the similarities between the US Chapter 11 and the pre-insolvency proceedings implemented in many jurisdictions, there are still some tools exclusively available in formal reorganization procedures (e.g., avoidance actions).

It seeks to interesting to observe how many countries are adopting the DFCH11 instead of implementing the features of the US Chapter 11 into their formal reorganization procedures. In other words, it is not clear why countries are not just replacing their formal reorganization procedures for a Chapter 11-style reorganization procedures. If so, they would not even need to implement (or amend) a pre-insolvency proceeding, since the Chapter 11-style reorganization procedures can serve as both pre-insolvency proceeding and formal reorganization procedure.

In my opinion, the adoption of a DFCH11 in a country´s pre-insolvency framework rather than adopting a formal Chapter 11 reorganization in their insolvency framework is probably explained by several factors. First, those jurisdictions adopting the DFCH11 might not want to recognize the failure of their formal reorganization procedures. Indeed, the rise of the DFCH11 may be the consequence of the inefficiencies of many insolvency regimes. These inefficiencies not only include the unavailability of certain tools that may facilitate a financial restructuring in a more efficient manner (e.g., cross class cramdown) but also the *stigma* associated with insolvency proceedings, which many generate several costs for both debtors and society as a whole. Ex ante, it may encourage debtors to minimize the risk of insolvency by reducing either the use of debt or their level of risk. In either case, value can be destroyed, since companies will have a lower access to finance and they will not have incentives to invest in risky but profitable, innovative projects. Ex post, the stigma associated with insolvency proceedings may lead to several costs. During the procedure, many employees, costumers and lenders may decide to terminate their business relationships with the debtor. Therefore, value can be destroyed for the company, the creditors, and society as a whole. After the procedure, debtors emerging from bankruptcy may lose part of their reputation or trustworthiness among market participants. Therefore, this stigma can also lead to several costs for society, including the loss of value associated with not financing valuable projects that can create wealth and jobs, as well as hampering entrepreneurship and access to finance. Hence, the existence of stigma can make an insolvency regime particularly harmful. And the more inefficient (or unattractive) an insolvency proceeding is, the more attractive other alternative solutions to bankruptcy might be.[51]

Some people may argue that the stigma associated with insolvency proceedings may be the result of a cultural or sociological problem.[52] Therefore, as getting rid of a

[51] Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2783666); Miguel García-Posada and Juan S. Mora-Sanguinetti, *Are there alternatives to bankruptcy? A study of small businesses distress in Spain*, 5 JOURNAL OF THE SPANISH ECONOMIC ASSOCIATION 287 (2014).

[52] A summary of the authors and arguments supporting this hypothesis can be found in Tibor Tajti, *Bankruptcy stigma and the second chance policy: the impact of bankruptcy stigma on business restructurings in China, Europe and the United States*, 6 CHINA-EU LAW JOURNAL 1 (2018); Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem?*

perception already inherent in a particular culture, it might make sense to forget about the stigmatized reorganization procedure and focus on enacting or improving the pre-insolvency or restructuring framework. However, I do not think this argument is entirely convincing. In my opinion, even if the stigma associated with insolvency proceedings is a cultural problem, the *origins* of this problem can probably be found on the legal and institutional framework existing in the country. For example, China and Spain are countries in which insolvency proceedings seem to be subject to a very high stigma.[53] While some people have stated that this stigma is due to the lack of bankruptcy, reorganization, or even entrepreneurial culture,[54] after a deeper analysis of the regulatory framework existing in both jurisdictions, perhaps the most reasonable explanation is not given by the 'culture' but by their institutions. Indeed, in China, insolvent debtors can be included in a list of 'untrustworthy' people. Spain, on other hand, still preserves a system of 'labelling debtors' existing since 1737,[55] and corporate directors, in addition to being disqualified and subject to a set of reputational and civil sanctions, can also be liable for the company´s debts.[56] Therefore, it will be rational for debtors operating in these countries to be afraid of becoming insolvent. In fact, this reason may help explain why these jurisdictions exhibit such as low rate of business bankruptcies.[57] Therefore, the explanation would not be found on the lack of bankruptcy or entrepreneurial 'culture' in these countries but on an unattractive regulatory framework that encourage debtors to afraid of becoming insolvent by minimizing ex ante the risk of insolvency or avoiding ex post the use of formal bankruptcy procedures once they become insolvent.[58]

Lessons from Spain, IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016.

[53] Tibor Tajti, *Bankruptcy stigma and the second chance policy: the impact of bankruptcy stigma on business restructurings in China, Europe and the United States*, 6 CHINA-EU LAW JOURNAL 1 (2018); Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016.

[54] See *supra*, note 52.

[55] For an analysis of this institution, see Aurelio Gurrea Martínez*, Hacia la supresión de la calificación del concurso*, 28 REVISTA DE DERECHO CONCURSAL Y PARACONCURSAL 107 (2018).

[56] See article 172 and 172 *bis* of the 2003 Insolvency Act.

[57] Analyzing the relative use of bankruptcy procedures around the world, see Stijn Claessens and Leora F. Klapper *Bankruptcy around the World: Explanations of Its Relative Use*, 7 AMERICAN LAW AND ECONOMICS REVIEW 253 (2005). Pointing out that Chinese bankruptcy procedures have been misused, see Liu Mingkang and Wei Chuyi, *Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential*, LAU CHOR TAK INSTITUTE OF GLOBAL ECONOMICS AND FINANCE THE CHINESE UNIVERSITY OF HONG KONG, WORKING PAPER Nº 62 (2017) (available at http://www.igef.cuhk.edu.hk/igef_media/working-paper/IGEF/igef%20working%20paper%20no.%2062%20english%20version.pdf). Analyzing the reasons and implications of the low use of bankruptcy procedures in Spain, see Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016; Marco Celentani, Miguel García-Posada and Fernando Gómez, *The Spanish Business Bankruptcy Puzzle,* FEDEA WORKING PAPER 2010-11 (2010); Miguel García-Posada and Juan S. Mora-Sanguinetti, *Are there alternatives to bankruptcy? A study of small businesses distress in Spain*, 5 JOURNAL OF THE SPANISH ECONOMIC ASSOCIATION 287 (2014).

[58] Aurelio Gurrea Martínez, *The low usage of bankruptcy procedures: A cultural problem? Lessons from Spain,* IBERO-AMERICAN INSTITUTE FOR LAW AND FINANCE, WORKING PAPER SERIES, Núm. 1, 2016; Marco Celentani, Miguel García-Posada and Fernando Gómez, *The Spanish Business Bankruptcy Puzzle,* FEDEA WORKING PAPER 2010-11 (2010).

A simple legal reform in these countries cannot quickly delete the stigma associated with insolvency proceedings. The anti-debtor environment existing in these countries have probably made an institutional problem a sociological one. Therefore, even if the legislator implements several policies to reduce the stigma associated with a situation of insolvency, it will not be easy to get rid of it. It will take time. However, some legal reforms may help. For instance, in the US, the legislator decided to use the word 'debtor' rather than 'bankrupt' to refer to insolvent debtors. In the UK, 'bankruptcy law' is no longer used for companies. Instead, this area of law is called 'insolvency law', and some authors even start to distinguish between 'insolvency law' and 'restructuring law'.[59] More interestingly, in Chile, the legislator decided to name the institution in charge of overseeing insolvency proceedings as 'Superintendence of Insolvency and *Re-entrepreneurship*' in an attempt to fight against the stigma traditionally associated with insolvency proceedings.[60]

A second reason to explain why many countries may have decided to amend their pre-insolvency frameworks instead of enhancing their formal reorganization procedures can be found on the *political costs* associated with implementing a major insolvency reform. Indeed, insolvency reforms might not be popular, especially if they are not conducted after a thoughtful economic analysis and therefore making the insolvency reform creates a Pareto improvement. Sometimes, politicians do not conduct this economic analysis of regulation and they enact some laws that may harm the interest of a variety of stakeholders (e.g., employees, banks, debtors, etc.). In other cases, this economic analysis is conducted, but a reform cannot be Pareto efficient but just Kaldor-Hicks efficient.[61] Therefore, it would generate winners and losers, even if the gains for the winners exceed the losses for the losers and the latter is compensated. Additionally, insolvency reforms imply high negotiation efforts, since an insolvency regime may affect a variety of stakeholders. This point becomes particularly relevant in the context of supranational organizations such as the European Union, where in addition to the internal disputes among different stakeholders, each country may have its own views about the role and goals of insolvency law. For this reason, it would be very difficult to harmonizing formal insolvency procedures.

In contrast, a reform of 'pre-insolvency' law seems much easier, not only because 'pre-insolvency' or 'restructuring' law sounds more appealing than 'insolvency' or 'bankruptcy' but also because pre-insolvency procedures usually involve fewer insolvency tools. Therefore, some may argue that a reform of pre-insolvency law may

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[59] Some authors even speak about 'insolvency law' and 'restructuring law' as part of the general concept of the 'law of corporate distress'. See Sarah Paterson, *Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century*, 35 OXFORD JOURNAL OF LEGAL STUDIES 1 (2015). For a distinction between 'insolvency law' and 'restructuring law', see also Stephan Madaus, *Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law,* 19(3) EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 615 (2018).

[60] For an analysis of the role played by this institution, see http://www.superir.gob.cl/

[61] About these concepts of efficiency, and why the concept of Kaldor-Hicks efficiency is more commonly used in practice than the concept of Pareto efficiency, see Richard Posner, ECONOMIC ANALYSIS OF LAW (Wolters Kluwer, 8th Edition, 2011), pp. 17-20; Rizwaan J. Mokal, *On Fairness and Efficiency*, 66 (3) MODERN LAW REVIEW 452, 454-156 (2003).

have a lower impact on a variety of stakeholders, even if this assertion is probably untrue.[62]

Finally, the rise of pre-insolvency law can also be due to the fact, or at least perception, that a pre-insolvency procedure may be more efficient than formal insolvency proceedings. In other words, it can be argued that a pre-insolvency mechanism provides a less costly solution to resolve the debtor´s financial trouble.[63] However, while it is true that pre-insolvency procedures may generate lower direct bankruptcy costs, and they may reduce other indirect costs associated with a situation of insolvency (e.g., reputational costs, underinvestment problems, etc.), other problems may arise. Namely, the use of non-formal insolvency mechanisms to deal with a debtor´s financial distress may generate other problems, including: (i) a situation of opportunism of debtors vis-à-vis creditors if the pre-insolvency mechanism does not provide enough protections to all interested parties; (ii) a situation of opportunism of some creditors vis-à-vis the debtor if the pre-insolvency mechanism does not provide effective tools to prevent holdouts; (iii) higher coordination problems if the pre-insolvency framework does not create a proper forum for discussing, sharing and analysing information; and (iv) enough devices to protect the successful reorganization of a viable company facing financial trouble. Therefore, it is not clear whether a pre-insolvency procedure is more desirable than an efficient reorganization regime.

Regardless of the reason leading to favour pre-insolvency over formal insolvency-proceedings, or whether this shift from 'insolvency' to 'pre-insolvency' law is more or less desirable, the truth is that most countries around the world seem to be adopting pre-insolvency proceedings in their restructuring framework. And this fact implies that, in addition to addressing other potential problems generated by this move,[64] legislators should adapt their formal reorganization procedures to this new era of pre-insolvency law. Otherwise, some inefficiencies might arise, as it will be mentioned in section 4.

3. Adapting the formal insolvency framework to the era of pre-insolvency law

The DFCH11 seeks to provide viable companies with an effective restructuring mechanism to sort out their financial trouble. Moreover, since debtors will save

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[62] Emphasizing that the new pre-insolvency framework established in the European Directive for Preventing Restructuring can affect a variety of stakeholders and the use of formal insolvency proceedings can provide a higher level of protection, see Horst Eidenmüller, *Contracting for a European Insolvency Regime*, 18 EUROPEAN BUSINESS AND ORGANIZATION LAW REVIEW 273, 289-291, 298-303 (2017).

[63] For an analysis of the features and advantages of pre-insolvency proceedings, see Nicolaes Tollenaar, PRE-INSOLVENCY PROCEEDINGS: A NORMATIVE FOUNDATION AND FRAMEWORK (Oxford University Press, 2019), pp. 38-80, 188-250.

[64] See Host Eidenmüller and Kristin Van Zwieten, *Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency,* ECGI LAW WORKING PAPER NO. 301/2015 (available at https://ecgi.global/working-paper/restructuring-european-business-enterprise-eu-commission-recommendation-new-approach). Emphasizing that the rise of 'pre-insolvency law', at least as it has been proposed in the European Directive, may create a refuge for non-viable debtors that may end up increasing financial costs for firms, see Horst Eidenmüller, *Contracting for a European Insolvency Regime*, 18 EUROPEAN BUSINESS AND ORGANIZATION LAW REVIEW 273 (2017).

significant costs by not filing for bankruptcy,[65] an out-of-court restructuring should also be in the interests of the creditors. Therefore, if a debtor does not reach a pre-insolvency agreement, or it does not even try, there will be reasons to believe that the company is not economically viable or the creditors do not trust the current shareholders/managers. In either case, the company should be liquidated to sell the assets individually or as a going concern, depending on whether the business is economically viable or not. As a result of this situation, I believe that the rise of the DFCH11 should lead to restrict the use of formal reorganization procedures. Otherwise, many debtors that do not deserve to be reorganized (i.e., non-viable firms and viable businesses managed by the wrong people) may opportunistically file for reorganization.[66] And if so, creditors may respond with an ex ante increase in the cost of debt, and jobs can lost if economically viable businesses managed by the wrong people are not quickly sold to third parties.

Opportunistic filings for reorganization can be reduced with ex ante or ex post mechanisms. Ex ante, debtors can be required to prove certain financial and viability requirements, as it happens in most countries around the world. According to this system, unless these financial requirements are shown to the court, the bankruptcy petition will be dismissed. Alternatively, courts can facilitate the commencement of reorganization procedures without imposing high burdens, as it happens in the United States. Under this model, the opportunistic use of reorganization procedures can be managed ex post, for example, dismissing the case or, in more severe cases, imposing sanctions to the insolvent debtors or its directors.

In the absence of a DFCH11, there are clearer reasons to favour a system of ex post control. On the one hand, it may save significant costs associated with postponing the commencement of a bankruptcy procedures. Namely, as the debtor has probably become insolvent already, it may be subject to enforcement actions initiated by its creditors. And if so, it may lose certain assets that can be essential for the continuation of a business that, in many cases, can be economically viable. Moreover, if the situation of financial distress is observed by certain stakeholders (e.g., costumers, employees, lenders), they may want to terminate their business or contractual relationships with the company. Thus, they will exacerbate the debtor´s financial trouble, and even destroy the viability of a previously viable business. Therefore, postponing the commencement of the insolvency proceeding can be costly, since financially distressed debtors will be losing value every day that they do not enjoy the protections and restructuring tools available in reorganization procedures.

On the other hand, the proof of certain financial requirements can create other problems. First, it will require a higher sophisticated of courts. Second, as a result of the higher involvement of courts, more resources will be needed. Third, in countries without reliable judicial systems (as it happens in many emerging economies), more involvement of courts may imply a higher risk of corruption. Finally, while conducting an insolvency test can be reasonably done by sophisticated courts, the assessment of

[65] See *supra*, note 33.

[66] The expression 'opportunistic filling for reorganization' used in this paper will refer to any situation in which a debtor, even in good faith, files for reorganization when it should not, usually because the company is not viable or the creditors do not trust the shareholders/managers.

other financial conditions potentially imposed ex ante (e.g., viability) can be more problematic.

Therefore, as a general rule, the use of ex post controls can be more efficient. However, this situation may change in countries with a DFCH11. In these jurisdictions, the risk of using formal reorganization procedures opportunistically increases, since the debtor may have two available options: (i) the DFCH11; and (ii) then, if the DFCH fails, the debtor can try an agreement through a formal reorganization procedure.[67] Therefore, many non-viable debtors or even viable business managed by the wrong people may opportunistically delay the commencement of liquidation procedures. Hence, the pie available for distribution may be reduced due to the costs incurred during this period. Moreover, many jobs can be lost if viable businesses are not quickly sold to third parties. As a result of this potential destruction of value, even if debtors do not finally use reorganization procedures opportunistically, lenders can respond with an ex ante increase in the cost of debt. Therefore, in order to avoid these inefficiencies, various reforms seem to be needed.

On the one hand, debtors seeking to use formal reorganization procedures in countries with a DFCH11 should be subject to stricter eligibility requirements. After all, if a debtor does not reach a pre-insolvency agreement, or it does not even try, there will be reasons to believe that the company is not economically viable or the creditors do not trust the current shareholders/managers. In either case, it will not the deserve to be reorganized.

In my opinion, these higher eligibility requirements should consist on three primary aspects. First, debtors should show that the going concern value of the firm is higher than its liquidation value.[68] Thus, they will prove that the company is economically viable in the sense that the assets are best allocated in their current use.[69].

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[67] Actually, the debtor will even have three options it also tries a purely contractual agreement (workouts) before considering more formal restructuring procedures.

[68] For a general overview about valuation methods in bankruptcy, see Kenneth Ayotte and Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 116 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1819, 1825-1831 (2019). Even though the value of a firm as a going concern can be a very subjective value, it can still provide a useful number to have in mind. This number should be compared with the value of the firm in a hypothetical orderly piecemeal liquidation. See *In Re Crowthers McCall Pattern, Inc*., 120 B.R. 279. Thus, the value of the firm in its current use will be ultimately compared with the value of the firm under one of the worse scenarios, which is a piecemeal liquidation. For a general analysis of the valuation of companies in financial distress, see Stuart C. Gilson, Edith S. Hotchkiss and Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REVIEW OF FINANCIAL STUDIES 43 (2000); Michael Christal and Rizwaan J. Mokal, *The valuation of distressed companies: a conceptual framework*, 3 INTERNATIONAL CORPORATE RESCUE 63 (2006); Kenneth Ayotte and Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 116 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1819 (2019); Nicolaes Tollenaar, PRE-INSOLVENCY PROCEEDINGS: A NORMATIVE FOUNDATION AND FRAMEWORK (Oxford University Press, 2019), pp. 99-113.

[69] For an analysis of the concept of viability, and why non-viable (or economically distressed) firms should be liquidated and viable companies just facing a problem of financial distress should be reorganized, see John Armour, *The law and economics of corporate insolvency*, ESRC CENTRE FOR BUSINESS RESEARCH UNIVERSITY OF CAMBRIDGE, WORKING PAPER 197 (2001), p. 4; Michelle J. White, *Does Chapter 11 Save Economically Inefficient Firms*? 72 WASHINGTON UNIVERSITY LAW QUARTERLY 1319 (1994); Alan Schwartz, *A Normative Theory of Corporate*

Second, the debtor should also show that it has the support of a minimum percentage of creditors as a means of proving that a reorganization agreement will be possible. Otherwise, the commencement of a reorganization procedure may not be justified, since the creditors will unlikely trust the shareholders/managers. Therefore, a liquidation procedure may seem more desirable. If the company is economically viable but the creditors do not trust the shareholders/managers, the company can be sold as a going concern in a liquidation procedure. If the creditors do not trust the shareholders/managers and the company is not even viable, the company´s assets should be sold piecemeal in a liquidation procedure. In either case, the commencement of a liquidation procedure will provide a more efficient solution. By contrast, if a reorganization procedure is opened, various risks may arise, especially if the managers are not replaced by sophisticated insolvency practitioners capable of quickly distinguishing between viable and non-viable firms *and* these insolvency practitioners are not required to maximize the interest of the creditors. In these conditions are not met, the commencement of a liquidation procedure may take more than expected, and value can be lost during the process.

Third, the debtor must explain why it did not use the pre-insolvency framework, or why the DFCH11 failed. Otherwise, despite the fact that there might be valid reasons to file for a formal reorganization procedure (e.g., lack of time to reorganize under the DFCH11 or inability to use avoiding powers as a way to bring certain assets that can facilitate the reorganization of a viable business), the risk of using reorganization procedures opportunistically will be too high, especially in jurisdictions where these procedures are not managed by a third party (e.g., administrator) but by the debtor itself (sometimes under the supervision of an insolvency practitioner). Indeed, in countries in which an administrator or judicial manager is appointed to run the company during the formal reorganization procedures, as it happens in the United Kingdom and Singapore, the risk of using reorganization procedures opportunistically will be lower, provided that the administrator has the duty to maximize the interest of the creditors. Indeed, if this duty is not imposed, administrators may have incentives favor reorganization over liquidation as a strategy to market themselves as experts in turning around companies in financial distress, or just because liquidation may have worse publicity. In contrast, in countries in which the debtor exclusively manages the insolvent firm, as it happens in the United States, or where the debtor remains in possession under the supervision of an insolvency practitioner appointed by the court (as it happens in countries like Spain, Chile or Colombia), the risk of using reorganization procedures opportunistically will be higher. In these jurisdictions, the debtor –even if it

Bankruptcy, 91 VIRGINIA LAW REVIEW 1199, 1200-1201 (2005); Michelle J. White, *The Corporate Bankruptcy Decision*, 3 (2) JOURNAL OF ECONOMIC PERSPECTIVES 129 (1989); Douglas G. Baird, *The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms*, CHICAGO WORKING PAPER IN LAW & ECONOMICS NO 43 (1997), pp. 9-10. In my opinion, even though, for simplicity and familiarity, it is more common to distinguish between viable and non-viable firms, it is more precise to speak about 'economically efficient firms' or 'economically inefficient firms'. After all, insolvency law should make sure that the assets are efficiently allocated and that is actually what some insolvency provisions such as the best interest of credit test seek to achieve. Therefore, the concept of 'viable firm' used in insolvency law should be understood as what some economists have called economically efficient firms. See Michelle, J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganization and Out-of-Court Debt Restructuring*, 10 (2) JOURNAL OF LAW, ECONOMICS, AND ORGANIZATION 268, 269-274 (1994).

is supervised by a third party– will have incentives to postpone the commencement of a liquidation procedure in the hope that its financial situation will improve in the future. After all, in addition to the sentimental value potentially attached to the business, if the shareholders have already lost everything, the existence of limited liability will prevent them from incurring further losses. Therefore, since the shareholders can recover part of their investments in the unlikely event that the company improves its financial situation, and the losses and expenses generated by keeping the firm alive will be borne by the creditors, shareholders will have incentives to delay the reorganization procedure even if the quick commencement of a liquidation procedure provides a more desirable outcome for the creditors and, in cases of viable businesses managed by the wrong people, even for the employees.

As an alternative approach to subjecting debtors to a higher scrutiny, jurisdictions implementing a DFCH11 may consider going beyond and implementing in their DFCH11 those features from formal reorganization procedures missing in the DFCH11 (e.g., avoidance actions). In these latter circumstances, however, the legislator should abolish the formal reorganization procedure existing in the country. Otherwise, there will be a duplication of reorganization procedures that not only can be misleading for debtors, creditors and other market participants, but it can also exacerbate some of the problems and inefficiencies generated by the lack of coordination between insolvency and pre-insolvency law.

4. Conclusion

Several countries and regions around the world, including Singapore, the United Kingdom, and the European Union, are amending their restructuring framework to implement a reorganization tool that looks like a US Chapter 11 reorganization. However, unlike in the United States, where unsuccessful reorganizations lead to Chapter 7 liquidations, companies using a DFCH11 are still allowed to use formal reorganization procedures. This paper has pointed out that, whereas the rise of the DFCH11 is not necessarily undesirable provided that some further protections are put in place, those jurisdictions implementing this restructuring should adapt their formal insolvency framework to this new era of 'pre-insolvency law'. Otherwise, some inefficiencies can be created from this lack of coordination between insolvency and pre-insolvency law.

Namely, it has been argued that, in this new era of pre-insolvency law, debtors seeking to use formal reorganization procedures should be subject to stricter eligibility requirements. After all, if companies do not use a pre-insolvency mechanism that may facilitate, at a lower cost, a financial restructuring by providing some tools traditionally existing in a Chapter 11 reorganization procedure, or these pre-insolvency agreements fail, there will be reasons to believe that either the company is not viable or the creditors do not trust the managers. In either case, the company will not deserve to be reorganized. Therefore, unless some enhanced controls are put in place to prevent these companies from using formal reorganization procedures, there will be an increase in the number of debtors opportunistically filing for reorganization. And if so, some costs can be created. Ex ante, creditors might respond with an increase in the cost of debt. Ex post, value can be destroyed if non-viable firms are allowed to use formal reorganization procedures, and jobs and wealth might be lost if economically viable businesses managed by the wrong people are not quickly sold as a going concern instead of being allowed to try (sometimes again) a reorganization agreement. Therefore, even though the ability to use reorganization procedures opportunistically will be more unlikely in jurisdictions where these procedures are managed by sophisticated insolvency practitioners rather than by the debtor itself (sometimes under the supervision of an insolvency practitioner), countries implementing a DFCH11 should make sure that their formal insolvency framework are adapted to this new era of pre-insolvency law.